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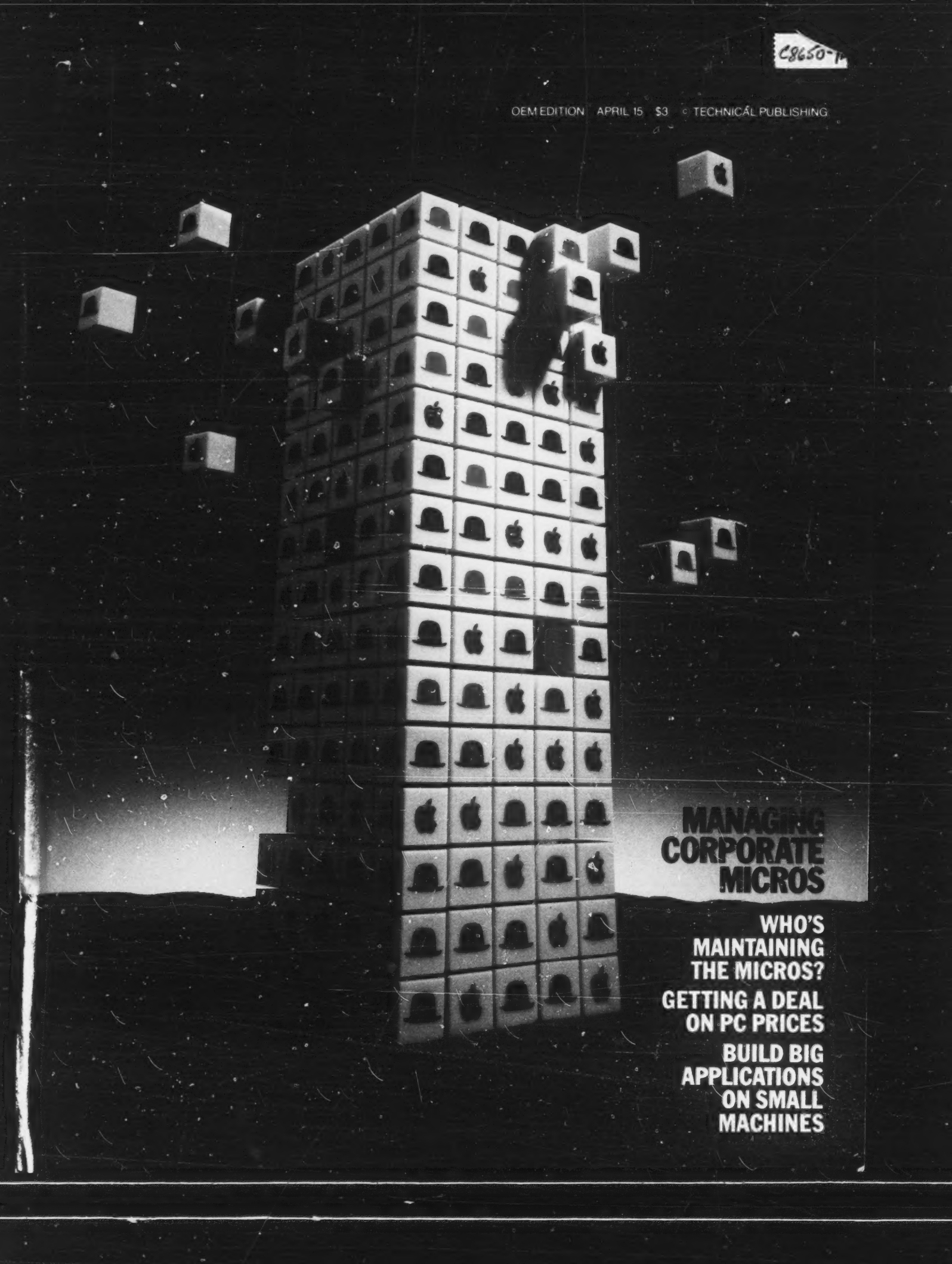

MANAGING CORPORATE MICROS

WHO'S MAINTAINING THE MICROS?

GETTING A DEAL ON PC PRICES

BUILD BIG APPLICATIONS ON SMALL MACHINES

DATAMATION

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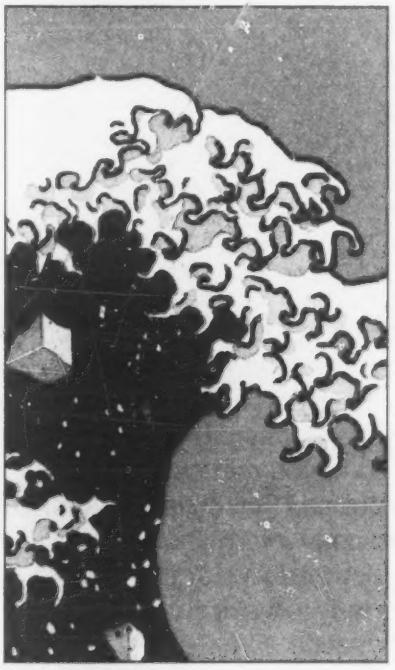

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- 1 **FINDING THE CASH**

COVER PHOTOGRAPH BY WALTER WICK

Venture, institutional, and public financing are available to resellers, but only to those who add value.

FINDING THE CASH

by Stephanie Miller Hills

A good idea is the first step. Hard work, finding a niche, and filling a need in the marketplace get a value-added reseller (var) up and running. But cash is the fuel that keeps the company growing. In order to find that cash, entrepreneurs must convince people who have little knowledge of reselling to invest in their firms.

Raising money to fund a reseller operation was never easy, but it appears that, this year, financial markets are opening up slightly. Some of the luster that high-tech companies had during their boom in the early 1980s is returning, although investors are more selective after suffering through the tough years of 1984 and 1985.

Communication is the key. Bankers, underwriters, and venture capitalists are willing to invest in vars but need to be educated about the market the reseller plans to serve and its opportunities.

The problem is that entrepreneurs and financiers speak different languages and have different perspectives on the computer business. It is up to the savvy entrepreneur who might already know how to sell his product to learn the language of the banker.

"The hard part for the entrepreneur is that he does not know how to do what he is going to have to do—get people to put money in his company," says Larry Fisher, president of Fisher Business Systems Inc., a var in Atlanta. "You're faced with the toughest challenge of all: running your company while you're out trying to raise money. That's the greatest pressure, and it's very difficult not to let one [of these efforts] suffer. Typically, you don't have anyone to whom you can turn over the reins."

For companies that need to raise $500,000 or more, the first place to look is the venture capital market. Arranging startup capital is the most difficult step, because a company often has few assets and no track record. In return for making an investment at this stage of the game, venture capitalists usually want a significant share of the new firm's equity—up to 80%—as well as the opportunity to participate in the company's management. Says Jeffrey Hamilton, a general partner with Euclid Partners, a New York venture capital firm, "If you're in a very early-stage startup with an untested management and product, you could put in a modest amount of money and get 30% to 40% of the company."

FISHER OF FISHER BUSINESS SYSTEMS: "The toughest challenge of all: running your company while you're out trying to raise money."

Venture capitalists believe that resellers have never ceased to represent an attractive investment opportunity for the financial community.

"The interest in the var business where you're packaging hardware, software, and peripherals for a particular market segment has always been there and is reasonably constant," says Hamilton. He distinguishes between these vars and those that just sell hardware without adding value in the form of proprietary technology, however.

Too often, the success of the var that simply moves hardware is a function of the policies of the hardware manufacturer. "It's always risky," Hamilton explains. "The big company could change the ground rules and wipe out the margin these smaller outfits generate from the hardware. [That margin] changes over the product life cycle."

VERTICAL MARKET INVESTMENT

Norman Fogelsong, general partner in the Mayfield Fund, a San Francisco-based venture capital firm, says he is willing to capitalize vars, although he looks at it as an investment in a specialized vertical market operation. "Our greatest interest is in individuals who have bootstrapped a product and are now at the point of taking it to the market and want to expand its distribution," he says.

Because of the nature of reselling, the analysis of the investment opportunity is different from what it would be for, say, a hardware manufacturer. "With a var, there is less likelihood of a unique proprietary technology," says John Shoch of the Asset Management Corp. in Palo Alto, "so you don't look for that in assessing the attractiveness of the deal. You look at the market and how the business plan is being executed."

Euclid's Hamilton agrees that the marketplace is the key. "Is the marketplace and the segment of the marketplace significantly attractive in terms of its size and growth potential?" he asks. "The greatest opportunity and product, if not executed well, will not work out. It all depends on the management."

It is in this area where venture capitalists often rely on instinct. Good communications skills can greatly enhance the attractiveness of the investment opportunity. "You don't know for sure about the management. You just spend enough time with the people and check them out and what they've done before. If you feel sufficiently impressed and you have the terms,

Some of the luster that high-tech companies had during the boom in the early 1980s is returning.

you go with them," says Hamilton.

Before the entrepreneur takes on new investors, he should review what he is getting in return. While the investors might be asking for 30% or more of the young company's equity, the owner should be wary of selling too much at a wholesale price. Larry Fisher found that the investment companies wanted to take 10% of his company in exchange for a $200,000 investment, a price he thought was too high. Usually, there are some incentives included in the deal where the entrepreneur can buy back a percentage of the company if it meets specified performance criteria.

Venture companies typically participate in the management of the company and take one or more seats on its board of directors. Each venture firm has different guidelines, and the degree of participation is based on the timing of the investment.

In the first round of financing, the entrepreneur has to ask what services he will be getting. If a var's investors can provide management guidance and help find future investors, it might be worth additional equity. For a company founded by technicians, this kind of investor participation can be an invaluable asset and an inexpensive way of getting high-priced administrative talent involved in running the company.

"In the early stages of startup, we spend a lot of time on the effort, assisting with staffing, planning, and testing the market," says Hamilton. "I've even gone out and helped a company market its product, because a lot of large companies are leery of buying from startup companies. They question whether [these new firms] have the financial resources. By going with them, you're standing behind them with the resources you have available."

This collaboration can be successful, however, only if the company's management and its investors can work together as a team. "If you don't feel that the investor has confidence in you, it's hard to have a good deal," warns Fisher. "It's hard for a small company to accurately forecast what it will be doing in the coming years, so sometimes you'll be behind plan. If you start out in an adversary position, it will get worse."

Resellers are best advised to seek investors who have funds available for the next round of financing or who know other investors. In this second stage, who the investor knows can be as important as what he knows. The venture firm also should be able to help with the selection of an underwriter when the company is ready to go public. It is important to keep in mind that, when assessing a purchase, stock market investors often look at the quality of the venture capital firms that have money invested in the company.

Typically, venture capital firms are more interested in companies in the second stage—with a proven track record and at least approaching profitability. Capital invested by venture firms in later-stage financing, as opposed to startup, rose from 25% in 1981 to 30% in 1984.

In the second round, the entrepreneur should be able to choose between competing venture firms, allowing him to cut a better deal and retain more control. In later financings, the company's valuation should be higher; the entrepreneur should receive more capital in exchange for selling less equity.

Going to a bank can be an alternative to later-stage equity financing. Commercial banks are courting smaller companies aggressively, although they usually stay away from startup situations. Donald Cvietusa, the head of Bank of America's high-tech lending area, says of the amounts and clients his group works with, "There are no minimums and, theoretically, no maximums; everything starts small. [When evaluating] a var, I would look at the product lines the var supports and whether those are likely to sell with the systems they put together, the market they are in, and the competition."

MORE THAN PEDDLING HARDWARE

Like venture capitalists, bankers insist that the resellers who come to them for financing do more than peddle some other company's hardware. Michael Yahng, head of the new ventures group at the First National Bank of Boston, says his bank will talk with vars but notes, "We're not too interested in lending to companies that don't add value. If there's no real technology that they're bringing to the party and all they're doing is being the middleman, that would not be attractive to us." He adds that the bank will consider deals with a minimum credit of $200,000, provided the company is in a region where the bank has other clients.

The interest rate the banks charge is a function of the strength of the company. Says Cvietusa, "The interest rate is determined by the [company's] size, [loan] term, and a judgment call on risks and administrative costs." The rates charged by these lending groups range from prime to prime plus 3%.

To approach a bank or venture capital firm, a company needs a business plan and past financial statements. "We like to see a company with a hockey stick profile that will be a meaningful and standalone company of $25 million to $50 million within five to seven years," says Yahng.

Many vars have few assets to support a loan, and they believe debt financing is not available to them as a result. Although banks prefer assets that are free and will use them to support a credit when the company is marginal, this is not absolutely necessary. If a company is well established, banks may consider the loan without attaching any assets.

Banks do not participate in the management of a company, but closely track their customer's progress against its plans and forecasts. Firms with proven track records can have their choice of banks. Tony Onorato, treasurer at TSR Computers, a Hauppauge, N.Y., var, went to several banks before he got a loan at prime. His company has a strong balance sheet and is very liquid with no long-term debt—all factors that appeal to bankers. "We had a choice of bank financing, bonds, or equity, but decided to save the other options for major purchases or acquisitions," he recalls.

Entrepreneurs should select the bank they work with not only based on the interest rate, but also on the services the bank offers. First National Bank of Boston, for example, provides cash management and international services, as well as stock transfer services and advice on choosing an investment bank when a company is ready to go public.

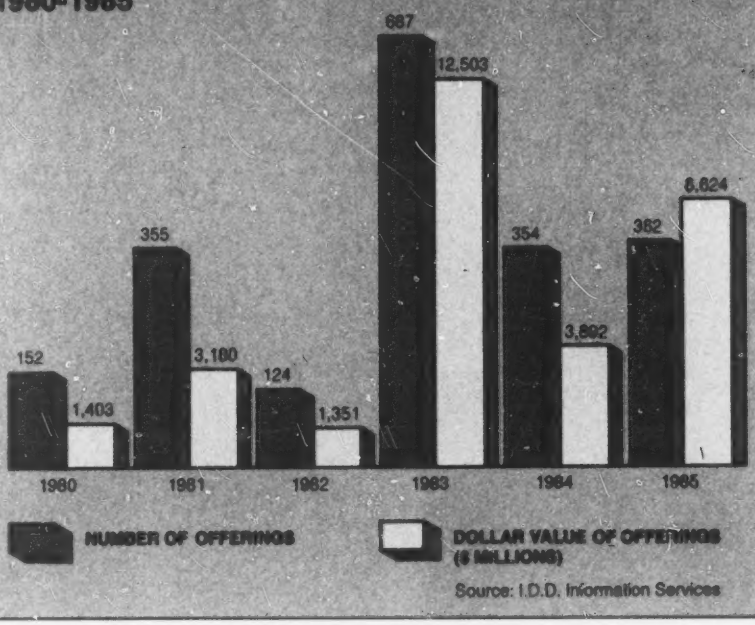
BIG ASSET DOESN'T SHOW UP

A problem in dealing with banks is that one of the vars' biggest assets is not fully recognized on the balance sheet. "My restaurant system that I wouldn't sell for a million dollars is valued at $50,000," says Fisher. "When you talk to a banker, all software companies look crappy." He got around this problem by building a good reputation with several banks over time, starting with an auto loan.

Fisher believes the secret of success with banks is keeping them up to date on how and what his company is doing. "It seemed logical, if they were going to be my partner sooner or later. Even when I had a small line of credit, I would go every quarter or six months and give them a status report. The difference between a reason and an excuse is [timing]. If you tell them that it is not going well this quarter and you have to borrow more money, it's no big deal. When you go rushing in at the eleventh hour, you begin to establish [a different] reputation."

There comes a time when a company's financial needs exceed even the deepest

FIG. 1
THE MARKET FOR INITIAL PUBLIC OFFERINGS: 1980-1985



Source: I.D.D. Information Services

pockets of the venture firms and the loans available from banks, and the stock market becomes an important source of additional capital. The initial public offering (IPO) market reached a peak in 1983 when a record $12.5 billion was raised by 687 companies, according to IDD Information Services in New York (see Fig. 1). Unfortunately, that pace has slowed, especially for high-technology stocks whose multiples reached dizzying proportions in the heyday of the IPO market.

"I would not say that people are chomping at the bit to get their hands on technology issues, but I would say a deal is possible now, which couldn't be said a year ago," comments Robert Natale, editor of *Emerging Issues and Special Situations* at McGraw-Hill Inc.'s Standard & Poor's unit. "The IPO market takes its lead from the general market conditions. The stock market has been good over the last couple of months, and technology issues have rebounded to some degree."

The IPO market is a definite possibility for vars, confirms Chris Covington, the director of corporate finance at regional investment firm Robertson, Colman & Stephens in San Francisco. He adds that Wall Street is little bit skeptical and for a familiar reason. "The question at hand is how great is the value added of value-added resellers. With IPOs, people are looking for continued growth."

Covington says that he would want to see historical and forecasted financial information, a business plan, and a well thought out strategy from companies considering going public. They also need to show a customer list, provide references, and include résumés of the executive management.

STOCK CAN BE BEST FINANCING

When the market is hot, the value placed on a company's stock can far exceed any other type of financing, notes Robert Riopel, executive vice president for finance at ASK Computer systems, a Los Altos, Calif., reseller. His company's stock sold for a multiple—defined as the price of the company's stock divided by its earnings per share—of 40 times historical earnings.

Unfortunately, multiples like ASK's seem to be a thing of the past. "When we had our initial offering, the world was starting to realize that companies like ours could grow to a significant size," Riopel remembers. "Everyone wanted to invest in the software market in 1982 and 1983, [but] from mid-1984 on, no one wanted to touch it. Now there seems to be more willingness to look at the individual company."

Because reselling is not an industry in particular favor with the stock market today, companies attempting to make a public offering need to be larger and more seasoned than in the past. In 1978, firms went public with sales of $10 million and profits of under $1 million, because investors had a sense of the worth of a proprietary position in a growing market.

Covington estimates that companies now need revenues of $40 million to $50 million and a net profit of at least $2.5 million to be of institutional interest and quality. "It's probably an industry of eight to 12 multiples and, as a consequence, in order to be worth being a public company, you have to have a valuation of $30 million and issue stock of $10 million," he says.

Investment banks handle the underwriting chores for an IPO. Because the fees a bank can charge for an initial offering are higher than those charged to an already public company, there is much competition. "The IPO business is a fair-traded item. The amount of the fee depends on the underwriter and the size of the offering," says Covington. Average fees can range from 7% for a $50 million deal to 7¾% or 8% for a $10 million offering.

The less attractive companies have to pay out a greater percentage to the underwriter. But if the banks want to establish a relationship with a company that will offer profit opportunities in the future, the fees will be lower. "There will be many houses banging at the door if [they see a future] need for additional underwriting, either debt or equity," says Natale of Standard & Poor's.

Investors in the IPO market look for companies with good track records, consistent or accelerating sales and earnings growth in successive quarters, backlogs of orders, and managements experienced in running larger firms. Natale believes that investors prefer professional over entrepreneurial management. "Entrepreneurial people often have trouble getting over the $100 million hump," he notes.

The quality of the underwriter and the original venture capital investors affects the offering's market reception. The first-tier investment banks are those that deal primarily with institutional investors; the second-tier banks are regional. The number of shares sold by current stockholders and venture capital investors also affect the offering. If only a few shares are sold by the stockholders, the market will perceive that they are willing to stay with the company. When the percentage of shares sold by a company's investors exceeds 40%, alarms go off in the minds of potential buyers. Such activity demonstrates to the market the small degree of faith the current investors have in the company.

More and more sources of financing are available to growing companies. The deregulation of the banking industry, coupled with new financing tools and increased competition, have worked in the entrepreneur's favor. A good track record and a well-defined business plan are the first steps in opening doors to financial institutions. Knowing the options, making contacts and and keeping them informed should make it easier for resellers to raise the capital they need to keep their businesses expanding. ◉

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